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Secretary Timothy F. Geithner
Testimony Before the Financial Crisis Inquiry Commission
Causes of the Financial Crisis and the Case for Reform
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Chairman Angelides, Vice Chairman Thomas, members of the Commission, thank you for the opportunity to testify.

Nearly eight decades ago, after a series of banking crises led to the Great Depression, the United States put in place broad protections over the financial system. These reforms – deposit insurance, prudential rules to limit risk-taking by banks, and improved transparency and investor protection in our securities markets – alongside the Federal Reserve's role as lender of last resort, laid the foundation for a more stable banking industry for several decades.

Over time, however, the financial system outgrew those protections. A large parallel financial system emerged outside of the framework of protections established for traditional banks. A great diversity of financial institutions emerged to provide banking services to individuals and companies, and they were allowed to operate without being subject to the same constraints applied to traditional banks. The shift in mortgage lending away from banks, the growth of the relative importance of non bank financial institutions, the increase in the size of investment banks, and the emergence of a range of specialized financing vehicles are all manifestations of this phenomenon.

The growth of this parallel financial system was made possible in part, and proved more damaging, because of a long period of relative economic and financial stability, encouraging borrowers and investors to take on more risk. Across the U.S. economy and around the world, trillions of dollars of financial decisions were made on the expectation that U.S. house prices would never fall, that future recessions would be short and shallow, that systemic crises in developed markets were a thing of the past, that liquidity and funding would be always available, and that the world economy would continue to grow unabated.

These judgments proved to be too optimistic. The entire financial system, and the borrowers and investors it served, did not attach enough importance to the possibility of a severe crisis. The protections put in place over the traditional banking system did not provide sufficient financial cushions or shock absorbers to withstand a deep recession and a substantial fall in real estate values. The parallel financial system, operating with much weaker protections, was even more vulnerable.

That is the story of this financial crisis. And addressing these failures is an essential part of the comprehensive financial reforms now being considered by the Congress.

The Emergence of the Parallel Banking System and Its Consequences

While the term "shadow banking" has been given different meanings in different contexts, we use it to describe the network of institutions and financial activities that provide basic banking-type services outside the scope of classic banking regulation.

At its core, banking is the business of taking deposits from "savers" and lending those deposits to borrowers. The basic tension in this business was perhaps best described by Jimmy Stewart in "It's A Wonderful Life" when facing a run on his bank. Stewart responds to a depositor who wants to withdraw his savings, "...the money's not here…your money's in Joe's house…and in the Kennedy House, and Mrs. Macklin's house, and, and a hundred others…" The challenge of banking is managing the mismatch between the needs of depositors who can demand their money at any time, and those of borrowers who take out a loan with no obligation to repay the funds for months or years.

The modern policy framework for banking emerged in the 1930s to address that inherent instability. It provides banks with lender-of-last-resort privileges and, for a fee, access to federal deposit insurance. But this support does not come without cost. It creates moral hazard and encourages banks to take excessive risks. Our regulatory system, which includes activity restrictions, capital requirements, and prudential supervision for banks is designed in part to constrain that excessive risk-taking.

But this regulatory system did not evolve to keep pace with growth and innovations in our financial services industry. The constraints imposed by banking regulation were significant enough to encourage activity to move away from banks in search of lighter regulation, lower capital requirements, weaker consumer protections, and better tax and accounting treatment.

Over time, the size of this parallel banking system grew to the point where it was almost as large as the entire traditional banking system. At its peak, this alternative banking system financed about $8 trillion in assets. Many of these assets were financed with short-term obligations and in institutions or funding vehicles with substantial leverage – leaving them with relatively thin cushions of resources to protect against the possibility of loss.

This parallel system came in many shapes and sizes. Independent investment banks like Lehman Brothers and Bear Stearns grew in size and financed themselves in the overnight repurchase agreement, or "repo" markets, which rely on assets or securities as collateral. Asset-backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs) were used by banks and a broad range of other financial institutions as funding vehicles for different types of assets. Specialized finance companies expanded into a broad range of consumer and business lending activities.

These institutions and funds were financed by institutional investors and by money market mutual funds, which purchased their short term commercial paper, or lent to them overnight in the repo markets secured by various forms of collateral.

Across this system, longer-term financial assets, which necessarily had some risk of loss, were financed short term, by investors and funds that had the right to withdraw their money or refuse to continue to fund a maturing obligation.

This parallel system was particularly vulnerable to a classic run or banking panic. As the crisis intensified, investors began to pull back. This forced institutions in the parallel financial system to sell assets to meet those demands. That pushed the price of financial assets down further, leading to more pressure on those institutions.

Unlike a traditional bank run, which is visible in lines outside of banks as people rush to withdraw their money ahead of a collapse, this run was led by institutional investors managing mutual funds and pension funds. The confidence investors had in the value or assigned rating of the collateral backing their loans or investments evaporated. While this panic might have been less visible than in the panics of years past, it was no less real.

As a result of this run, aggressive policy measures were required to prevent a second Great Depression. The Federal Reserve, acting under its emergency authorities, launched an unprecedented expansion of support to preserve liquidity in the parallel banking sector, lending against collateral held by primary dealers in investment banks, providing a backstop to commercial paper markets. The Treasury Department used its existing authority to supply a temporary guarantee of the money market fund industry. The FDIC implemented additional liquidity measures to stabilize the funding base of the regulated banking system, including a debt guarantee program and significant expansions of deposit insurance. Congress enacted the Emergency Economic Stabilization Act, making it possible for the Treasury Department to make preferred equity investments in banks across the country.

How Did This Happen?

Despite the fact that many call this the shadow banking system, it was not hidden. It was operating in broad daylight and financed by sophisticated institutional investors with bonds issued under the disclosures and protections of the securities laws. And unlike the moral hazard risk in banks and the GSEs, this market grew up without any explicit or implicit government insurance or any history of government support in a crisis. This was a pure failure of market discipline.

Why did the system of oversight in place for decades following the Great Depression not protect against the growth of risk in this parallel system?

The history of this crisis is full of examples where regulators did not use the authority they had early enough or strongly enough to contain risks in the system. But a principal cause of the crisis was the failure to provide legal authority to constrain risk in this parallel financial system.

Prudential regulations were limited to banks, and did not extend to the parallel financial system.

The Federal Reserve did not have any legal authority to set and enforce capital requirements on the major institutions that operated banking businesses outside of bank holding companies, no legal authority over the investment banks, diversified financial institutions like AIG, or the hundreds of non bank finance companies competing with banks in the mortgage, consumer credit, and business lending markets.

The SEC had no legal authority to set and enforce capital requirements on a consolidated basis across the full range of activities of the investment banks.

The Office of Thrift Supervision became the holding company supervisor for an array of large complicated financial institutions like AIG, without having the ability to supervise them effectively on a consolidated basis.

No single entity had the authority to act to limit the emerging risk in funding markets financed by money market funds.

No regulator or supervisor had the legal authority to look across the financial system and take action to prevent the diversion of activity away from regulation. A system that applied safety and soundness regulation only to banks was unable to protect the overall safety and stability of a financial system composed substantially of non-banks that played a role traditionally reserved for banks.

Moreover, accounting and disclosure requirements and regulatory capital requirements helped encourage the shift in risk to the parallel financial system, without adequately capturing the remaining exposure of banks to those risks.

When the crisis hit and huge swaths of the American financial system got caught in the run on the parallel banking system, many came running to the Federal Reserve for liquidity and for protection.

The emergency financial response to the run that started in the parallel financial system was necessary to protect our economy from an even greater calamity. But if our regulatory and supervisory systems had had the tools and authorities to prevent risks from accumulating in unregulated sectors of the financials system in the first place, such a large emergency response would not have been necessary. That is a key reason why financial reform is so essential.

Financial Reform

The financial reform proposals now being considered by the Congress have been crafted to address these and other failures and they are being complemented by enhanced regulatory oversight of key aspects of the shadow banking system.

- *Comprehensive Constraints on Risk Taking.* The proposed reforms will require the enforcement of more conservative capital and leverage requirements on the activities, whether on or off balance sheet, of all major financial institutions. A company like AIG or Lehman Brothers will not be able to escape consolidated supervision by virtue of its corporate form, and will have to operate on a level playing field with large commercial banks and traditionally regulated financial institutions.

- *Repo Markets*. These reforms will give the Federal Reserve the authority to build a more stable funding system, take action to address the unstable aspects of the short-term repo markets, and ensure that these markets are used much more conservatively in the future. These steps will give clear authority to set risk management requirements for these markets, including capital standards, set standards for collateral requirements, and to help ensure that settlement procedures are robust. They will also create enforcement authority to compel corrective actions as risks build up, or when risk-management is inadequate. These authorities will also reinforce stability and liquidity even in times of market stress such as a terrorist attack or acute financial crisis.

- *Higher Standards for Money Market Mutual Funds.* The SEC recently enacted new rules to strengthen liquidity, credit standards and disclosure in the money fund industry. More work remains to be done in this area, and the President's Working Group on Financial Markets is preparing a report setting forth options to reduce the susceptibility of money funds to runs.

- *Rating Agencies, Disclosure, and Accounting.* These reforms will provide the SEC with authority to limit conflicts of interest, require greater disclosure to ensure more diversity in ratings, and require regulators to reduce the overall reliance on ratings throughout the supervisory system. The SEC will require more extensive disclosure, including loan-level data for asset-back securities, to ensure that investors have the information they need to make informed decisions. Changes underway to accounting standards will result in greater transparency for a firm's off-balance sheet commitments, improve standards, and move forward international accounting convergence.

- *Derivatives.* These reforms will bring comprehensive oversight and transparency to the OTC derivatives markets. These markets have proved to be a major source of uncertainty and risk during periods of financial disruption. The proposed reforms will bring the bulk of these trades into central clearing arrangements, ensuring full transparency and reducing the degree to which financial contagion can spread due to real or perceived counterparty credit exposures. All dealers and major market participants will be subject to tough prudential standards, including margin and capital requirements. And the SEC and CFTC will have full enforcement authority to set position limits and address fraud, manipulation, and abuse.

- *Resolution Authority*. These reforms will establish a resolution regime that will give the government the necessary tools to safely put failing financial institutions out of existence without causing a panic or destabilizing credit markets, and without exposing the tax payer to the risk of loss.

Conclusion

When people look back at this crisis, when they look at the excessive risks taken by large financial institutions, the natural inclination is to move those risky activities elsewhere. To create stability, some argue, we should just separate banks from "risk."

But, in important ways, that is exactly what caused this crisis.

The lesson of this crisis, and of the parallel financial system, is that we cannot make the economy safe by taking functions central to the business of banking, functions necessary to help raise capital for businesses and help businesses hedge risk, and move them outside banks, and outside the reach of strong regulation.

Mr. Chairman, let me close by thanking the Commission for your important work in drawing public attention to one of the key factors in this crisis, and one of the most important objectives of financial reform.